Office of Chief Counsel Internal Revenue Service

memorandum

CC:WR: : TL-N-2986-99

date: June 20, 2000

to:

Team Coordinator Examination Division,

from:

Attorney

subject:

; R&E Credit on

accrual)

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client, deliberative process and attorney work product privileges. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Collection, Criminal Investigations, Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

The analysis contained in this advice is not binding on Examination or Appeals and is not a final case determination. It does not represent the position of Chief Counsel or the Internal Revenue Service on any issue and does not provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

The attached document contains my suggestions for a Notice of Proposed Adjustment. As we discussed, it expands on the position in the draft you sent me on April 20, 2000.

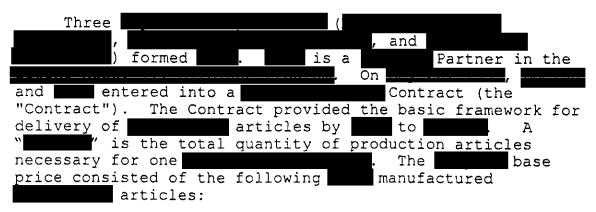
I have also returned your floppy disk, and added a copy of the suggested version of the Notice of Proposed Adjustment to the disk.

Accorney

Issue:

Is the taxpayer entitled to accrue a liability for "and "and "done by (), and then treat the accrued liability as "supplies, "and thus qualifying research expenditures (QRE) pursuant to section 41(b)(2)(C)?

Facts:



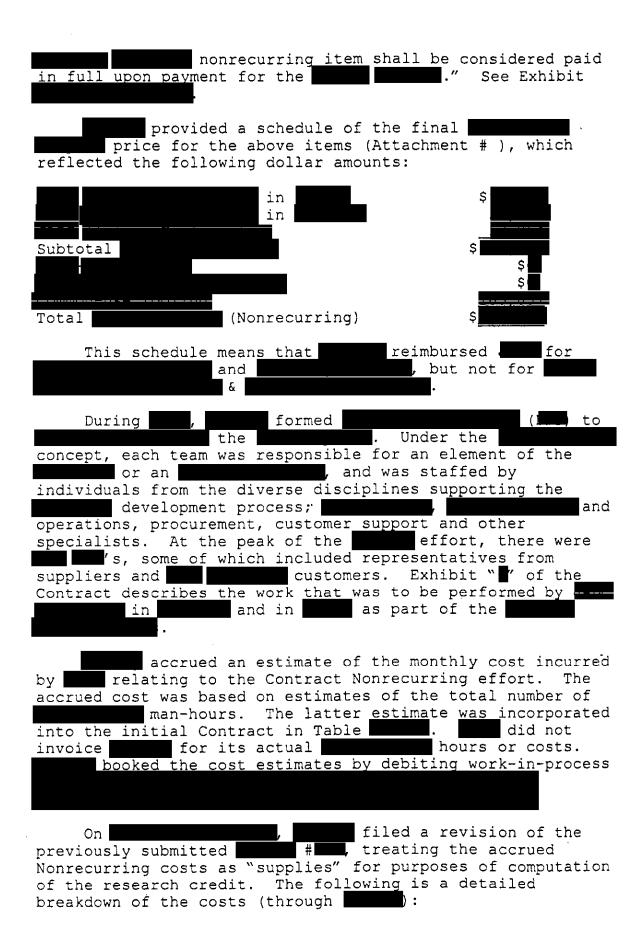


were priced at \$1 each, while were priced at \$1 each. Exhibit provides a breakdown of these prices by article.

guaranteed payment for the Nonrecurring items under the Contract. See Exhibit , "Prices for Nonrecurring." The Nonrecurring items included:



As delivered a delivered a sales price included a charge for a portion of the incurred Nonrecurring effort as well as the actual cost to make the Contract provided that "the total contract price for each





Law:

- I.R.C. § 41(b)(2) In-house research expenses.
 - (A) In general. The term "in-house research expenses" means
 - (i) any wages paid or incurred to an employee for qualified services performed by such employee,(ii) any amount paid or incurred for supplies used in the conduct of qualified research . . .
- I.R.C. § 41(b)(3) Contract research expenses.
 - (A) In general. The term "contract research expenses" means 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee of the taxpayer) for qualified research.
- I.R.C. \S 41(b)(2)(C) Supplies. The term "supplies" means any tangible property other than -
 - (i) land or improvements to land, and(ii) property of a character subject to theallowance for depreciation
- I.R.C. § 41(d)(4) Activities for which credit not allowed. The term "qualified research" shall not include -
 - (F) Foreign research. Any research conducted outside the United States.
- I.R.C. § 461(a) General Rule.--

The amount of any . . . credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

- I.R.C. § 461(h) Certain liabilities not incurred before economic performance.
- (2) Time when economic performance occurs. Except as provided in regulations prescribed by the Secretary, the time when economic performance occurs shall be determined under the following principles:
 - (A) Services and property provided to the taxpayer. If the liability of the taxpayer arises out of
 - (i) the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services,
 (ii) the providing of property to the taxpayer by another person, economic performance occurs as the person provides such property, or
 (iii) the use of property by the taxpayer, economic performance occurs as the taxpayer uses such property.

's Position:

maintains that it contracted for an end product at a fixed price, and that this end product was used in the performance of qualifying research. contends that those end products are "supplies" under I.R.C. § 41(b)(2)(C).

Service's Position:

The Internal Revenue Service does not agree that can accrue amounts which have not been invoiced by treat the payments as QRE. We note the following problems:

- 1. is treating cost estimates as QRE, even though under the economic performance rules, the costs cannot be accrued for tax purposes.
- 2. has accrued the costs of Nonrecurring effort. In this case, the items accrued are even described as "planning" and services". The "Effort" is either a service or, possibly, an intangible asset. However, only tangible property may qualify as "supplies". I.R.C. § 41(b)(2)(C). The only tangible property delivered to

by was the way, and has not explained why the are supplies. (Most or all of the costs of seem to be costs, and not supplies.)

- 3. is treating services as QRE.

 Most of these services were performed in services were performed in services were "research", the costs could not be QRE. I.R.C. § 41(d)(4)(F)(concerning foreign research).
- 4. Tooling is property of a character subject to the allowance for depreciation, and does not qualify as "supplies". I.R.C. § 41(b)(2)(C)(ii).

Each of these arguments is discussed in greater detail below.

Economic Performance:

No credit can be claimed until the year of the expenditure under its method of accounting. I.R.C. § 461(a). The economic performance rules determine whether a liability has been incurred with respect to any item. If a liability of the taxpayer arises out of the providing of property by another person, economic performance occurs as the person provides such property. I.R.C. § 461(h)(2)(A)(ii). Economic performance is deemed to occur only upon delivery because until then the taxpayer does not have use of the property.

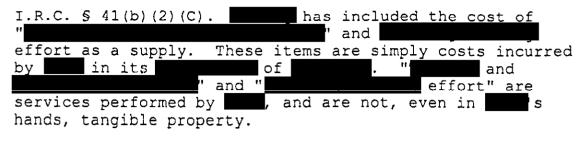
and not services (as explained below, if provided services, the costs were not QRE).

billed for Nonrecurring effort as it delivered the form, as provided by Article of the Contract. The invoice sales price included a pro-rata share of the total Nonrecurring costs incurred. accrued contract costs before it had received the formula, and based the amount of the accrual on a predetermined estimate of labor.

is not permitted to accrue the cost of the Nonrecurring effort until the delivery of the economic performance occurred. Costs which have not been, and cannot be accrued, are not QRE.

Effort is not a Supply:

The term "supplies" means any tangible property other than (i) land or improvements to land, and (ii) property of a character subject to the allowance for depreciation.



Perhaps is claiming that the cost of the Nonrecurring items will eventually (and inevitably) be passed on to it as part of the cost of the However, has not provided any justification of its treatment of the sas supplies, and has not explained why nonrecurring costs incurred in connection with all should be treated as supplies; it cannot be true that all of the same are supplies (of the were not used in prototypes, the only for which even argues for "supply" treatment).

Foreign Research:

As noted above, appears to have performed "services" for the costs incurred by appear to be similar to costs incurred by which has included in its QRE claim pursuant to I.R.C. § 41(b)(2)(A)(i). If the performed by constitutes research, so does the performed by

can only deduct the cost of services performed by an outside contractor if the services constitute contract research. I.R.C. § 41(b). However, if performed research for in an analysis cannot treat its payments for such research as QRE. I.R.C. § 41(d)(4)(F).

Depreciable Property is not a Supply:

Property of a character subject to the allowance for depreciation is not a supply for purposes of I.R.C. § 41. The only tangible property delivered to was the Any tangible property of a character subject to the depreciation allowance, regardless of whether the taxpayer is claiming depreciation with respect to the property, is not a supply.